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No. 01-147

IN THE

Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES ZANDFORD,
Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Fourth Circuit

BRIEF OF NASD REGULATION, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether a stockbroker's fraud is "in connection with the * * * sale" of securities under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5, when the stockbroker sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

INTEREST OF *AMICUS CURIAE* 1

STATEMENT 2

SUMMARY OF ARGUMENT 6

ARGUMENT 7

THE COMMISSION HAS CLEARLY STATED A COGNIZABLE VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 UNDER SETTLED LAW 7

A. Respondent's Deceptive Scheme Was Executed "In Connection With" The Sale Of Securities 8

B. The Federal Interest In Protecting Investors Counsels In Favor Of Extending Liability To Respondent's Conduct 12

C. The Decision Below Creates A Potential Gap In The Protection Afforded To Investors In The Federal Securities Markets 15

CONCLUSION 20

TABLE OF AUTHORITIES

Page(s)

CASES

Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) 14

Basic Inc. v. Levinson, 485 U.S. 224 (1988) 13

Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964) 10

Dist. Bus. Conduct Comm. v. Bavero, No. C9A920035, 1993 NASD Discip. LEXIS 227 (Sept. 7, 1993) 16

Dist. Bus. Conduct Comm. v. Roach, No. C02960031, 1998 NASD Discip. LEXIS 11 (Jan. 20, 1998) 16

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 13, 19

Ex parte Robinson, 86 U.S. (19 Wall.) 505 (1874) 18

In re Charles Zandford, 50 S.E.C. 782, Release No. 29,901, 1991 WL 288257 (Nov. 5, 1991) 4

Lang v. French, 154 F.3d 217 (5th Cir. 1998) 18

Marine Bank v. Weaver, 455 U.S. 551 (1982) 13

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD, 616 F.2d 1363 (5th Cir. 1980) 1, 15

Rubin v. United States, 449 U.S. 424 (1981) 13

Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) 12, 14, 15

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) 13

Silver v. New York Stock Exch., 373 U.S. 341 (1962) 15

TABLE OF AUTHORITIES—*Continued*

Page(s)

Sparta Surgical Corp. v. NASD, 159 F.3d 1209 (9th Cir. 1998)..... 2, 15

Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971)..... 6, 8, 9, 10, 13

United States v. Naftalin, 441 U.S. 768 (1979)..... 13, 14, 15

United States v. O'Hagan, 521 U.S. 642 (1997)..... 6, 11, 12, 13, 14

United States v. Zandford, 181 F.3d 94 (4th Cir. 1999)..... 4

Zandford v. NASD, 19 F. Supp. 2d 1 (D.D.C. 1998)..... 4

Zandford v. NASD, 19 F. Supp. 2d 4 (D.D.C. 1998)..... 4

Zandford v. NASD, 30 F. Supp. 2d 1 (D.D.C. 1998), *aff'd*, 221 F.3d 197 (D.C. Cir. 2000)..... 4

STATUTES

15 U.S.C. § 77q(a)..... 4, 6

15 U.S.C. § 78bb(a)..... 13

15 U.S.C. § 78j(b)..... 4, 6, 7

15 U.S.C. § 78o *et seq.*..... 1

15 U.S.C. § 78o-3 *et seq.*..... 1

15 U.S.C. § 78u(e)..... 18

18 U.S.C. § 1343..... 4

TABLE OF AUTHORITIES—*Continued*

Page(s)

REGULATIONS

17 C.F.R. § 240.10b-5..... 4, 6, 7

Notice Of Filing Of Proposed Change And Amendment No. 1 Thereto By The National Association Of Securities Dealers, Inc. Relating To The Issuance Of Temporary Cease And Desist Orders, 63 Fed. Reg. 71,984 (December 30, 1998)..... 17, 18

RULES

FED. R. CIV. P. 65..... 17

NASD Bylaws, art. IV, § 1..... 17

NASD Bylaws, art. V, § 2..... 17

NASD Procedural Rule 8210..... 16, 17

NASD Procedural Rule 8310..... 16

OTHER AUTHORITIES

ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD (2d ed. 2001)..... 11

Alexander H. Frey, *Federal Regulation Of The Over-The-Counter Securities Market*, 106 U. PA. L. REV. 1 (1957)..... 19

INVESTMENT COMPANY INSTITUTE AND THE SECURITIES INDUSTRY ASSOCIATION, EQUITY IN AMERICA (Fall 1999)..... 14

LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION (4th ed. 2001)..... 10, 11

BRIEF OF NASD REGULATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

NASD Regulation, Inc. ("NASD Regulation") is the regulatory subsidiary of the National Association of Securities Dealers, Inc. ("NASD"), a private, not-for-profit corporation organized under the laws of Delaware. The NASD is a self-regulatory organization registered with the Securities and Exchange Commission ("SEC" or "Commission") as a national securities association pursuant to the Maloney Act of 1938, 15 U.S.C. § 78o-3 *et seq.* (amending Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78o *et seq.*).[1] The NASD "plays an important role in [the] complex self-regulatory scheme carefully set down by Congress." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363, 1368 (5th Cir. 1980). Congress, through the Exchange Act, has assigned the NASD the responsibility for conducting investigations and commencing disciplinary proceedings against member firms and their associated representatives to further compliance with the federal securities laws and NASD Rules. In 1996, the NASD created NASD Regulation as a wholly-owned subsidiary and delegated to it NASD's regulatory functions. Through its registration, examination, and disciplinary procedures, NASD Regulation operates as the first line of defense against fraud and misconduct in the federal securities markets.

The question presented in this case is whether a stockbroker violates Section 10(b) of the Exchange Act and Rule 10b-5 by trading his clients' securities without authorization

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief have been filed with the Clerk. Pursuant to this Court's Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amicus*, its members, or its counsel made a monetary contribution to the preparation or submission of this brief.

and misappropriating the proceeds of those transactions for his personal use. *Amicus* has a vital interest in correct resolution of that question because—as the "primary regulatory body for the broker-dealer industry" (*Sparta Surgical Corp. v. NASD*, 159 F.3d 1209, 1210 (9th Cir. 1998))—it has a significant stake in ensuring that the investing public is protected from such unscrupulous securities practices. In particular, *amicus* believes the decision below conflicts with this Court's precedents and creates a potential gap in the protection afforded to investors by the federal securities laws. NASD Regulation's authority to discipline NASD member firms and their associated persons for violating the federal securities laws is subject to significant limitations; its enforcement powers were intended only to complement the Commission's broad regulatory powers in this area. Because affirmance of the decision below could leave investors insufficiently protected against misconduct by securities traders, *amicus* respectfully submits this brief to assist the Court's consideration of the case.

STATEMENT

From 1987 to 1990, respondent Charles Zandford was employed as a stockbroker at Dominick & Dominick ("Dominick"), a brokerage firm located in Bethesda, Maryland. Pet. 27a. In September 1987, respondent convinced William R. Wood to open a joint investment account at Dominick. *Id.* The account was registered in Wood's name and in the name of his daughter, Diane Wood Okstulski. The stated objective for the account was "safety of principal and income." *Id.*

Wood made an initial deposit of $130,000 into the account in September 1987 and gave respondent an additional $289,000 to invest in March 1988. Pet. 27a-28a. The monies given to respondent by Wood constituted the entirety of Wood's life savings. Pet. 27a. At the time he opened the account, Wood was 71 years old and in poor health; his daughter, Okstulski, suffered from severe psychological disorders and was not competent to make independent financial

decisions. Pet. 27a-28a. In April 1988, Wood suffered a debilitating stroke and was thereafter hospitalized or cared for in a nursing home. Pet 28a. He died in 1991. *Id.*

Shortly after Wood's hospitalization in 1988, respondent began to perpetrate a financially devastating fraud on Wood and Okstulski. Pet. 28a-29a. On at least three occasions, respondent sold securities in a separate mutual fund account maintained by Wood and Okstulski and issued to himself checks that were drawn on that account. Pet. 28a. Respondent also sold securities in the Wood-Okstulski investment account and obtained a check from Dominick for the amount of the proceeds and deposited it into a bank account under his control. Pet. 29a. In addition, respondent drafted checks made payable to Wood and Okstulski and deposited them into accounts he owned and controlled. Pet. 29a. The cash used to honor those checks was generated by the sale of securities in either the mutual fund or joint investment account. Pet. 29a.[2]

By September 1990, respondent's deceptive scheme had completely depleted the value of the $419,000 that Wood had given respondent to "conservatively invest." Pet. 34a. Respondent used the proceeds from these various transactions for his own purposes, including the purchase of new cars, the payment of his credit card bills, and the purchase of securities and gifts for his girlfriend. Pet. 29a, 34a, 42a.

Respondent's fraud was first detected by the NASD pursuant to its self-regulatory duties during a routine examination of his employing firm, Dominick. *See* Pet. 34a. The NASD referred the matter to federal law enforcement authorities. In April 1995, a federal grand jury returned a su-

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[2] Respondent apparently had discretionary trading authority over the joint investment account. *See* Pet. 10a. Respondent has never contended, however, that such "discretion" authorized him to trade securities for his own benefit or to use the proceeds from those transactions for his personal use.

perseding indictment charging respondent with 13 counts of wire fraud in violation of 18 U.S.C. § 1343. The indictment alleged that respondent engaged in a scheme to defraud by "caus[ing] checks to be issued against the security positions of * * * Wood and * * * Okstulski made payable to [himself], thereby causing their securities to be liquidated." Pet. 41a. After a three-week trial, respondent was convicted on all counts and was sentenced to a prison term of 52 months. Pet. 35a. His conviction and sentence were affirmed on direct appeal and on collateral review. Pet. 33a-39a (direct appeal); *United States v. Zandford*, 181 F.3d 94 (4th Cir. 1999) (unpublished) (habeas).[3]

On September 26, 1995, petitioner Securities and Exchange Commission filed a civil complaint against respondent alleging violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. The complaint alleged that respondent violated those laws by engaging in excessive trading in the joint investment account, selling securities in Wood's ac-

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[3] The 1995 wire fraud conviction was not the first time petitioner encountered legal difficulties arising from his conduct as a broker-dealer. In 1987, the NASD initiated disciplinary proceedings against petitioner for misconduct he allegedly committed while working as a broker-dealer for Prudential-Bache Securities, Inc. ("Prudential"). Petitioner was found by the NASD to have improperly deposited personal funds into a customer's account and was fined and censured, but the Commission set aside that determination on appeal. *See In re Charles Zandford*, 50 S.E.C. 782, Release No. 29,901, 1991 WL 288257 (Nov. 5, 1991). Petitioner subsequently initiated a rash of civil suits against Prudential, NASD, and several of their respective employees. *See, e.g., Zandford v. NASD*, 30 F. Supp. 2d 1 (D.D.C. 1998) (dismissing complaint), *aff'd*, 221 F.3d 197 (D.C. Cir. 2000).

Petitioner also sued the NASD for its regulatory oversight activities concerning petitioner's securities trading at Dominick. *See, e.g., Zandford v. NASD*, 19 F. Supp. 2d 1 (D.D.C. 1998) (dismissing complaint); *Zandford v. NASD*, 19 F. Supp. 2d 4 (D.D.C. 1998) (same).

count without authorization, misappropriating $343,000 in proceeds, and using the money for his own purposes. Pet. 27a-30a.

The district court granted the Commission's motion for partial summary judgment on its misappropriation claims.[4] The district court reasoned that respondent's prior conviction for wire fraud "was based on the same facts alleged by the Commission against [respondent] * * * concerning misappropriations" and that the "criminal judgment of conviction established * * * all the elements * * * of [the Commission's] claims." Pet. 16a, 22a. Because respondent was "collaterally estopped" from "relitigating the facts underlying his conviction," and because the conduct which gave rise to respondent's conviction for wire fraud "has been consistently viewed by the SEC as a violation of Section 10(b) and Rule 10b-5," the district court concluded that respondent's scheme "violated the securities laws invoked" by the Commission "as a matter of law." Pet. 16a-17a, 22a. Significantly, the district court enjoined respondent from committing future violations of the securities laws and ordered him to pay disgorgement in the amount of $343,000. Pet. 22a.

The court of appeals reversed. Pet. 14a. The court of appeals rejected the district court's conclusion that collateral estoppel barred respondent from contesting his liability to the Commission, reasoning that the Commission's allegations under Sections 17(a) and 10(b) required proof that respondent "committed fraud 'in the offer or sale' of securities, or 'in connection with' the purchase or sale of securities," whereas "to find [respondent] guilty of wire fraud it was wholly unnecessary to determine whether his fraud was sufficiently connected to a securities transaction." Pet. 4a-5a

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[4] The Commission did not seek summary judgment on its allegations of excessive trading and did not object to the district court's entry of a "final judgment" in connection with its ruling on the summary judgment motion.

(citing 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5).

The court of appeals also rejected the district court's "legal conclusion" that the conduct for which respondent was convicted constituted a violation of the federal securities laws. Pet. 5a. To state a valid claim under Section 10(b) or Rule 10b-5, the court of appeals stated, the Commission was obliged to allege that respondent "influenced an[] investment decision by the Woods," "misled the Woods about the relative merits or value of particular securities," or "ma[d]e a[] reference to the attributes of a specific security." Pet. 9a-10a. Instead of meeting that standard, the court of appeals opined, the Commission's complaint alleged that "[respondent's] fraud lay in *absconding* with the proceeds of the sales," that any securities trades were merely "incidental" to respondent's scheme to "steal the Woods' assets," and that the Commission in effect had stated claims for "ordinary state law fraud or conversion" rather than "federal securities" violations. Pet. 7a-9a, 12a (emphasis added). Accordingly, the court of appeals reversed the grant of summary judgment for the Commission and remanded the case to the district court with instructions to dismiss the complaint.

SUMMARY OF ARGUMENT

The judgment of the court of appeals cannot be reconciled with this Court's cases construing Section 10(b) and Rule 10b-5, which make clear that the "in connection with" requirement is satisfied so long as a scheme to defraud has a relationship to or nexus with a securities transaction. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *United States v. O'Hagan*, 521 U.S. 642 (1997). Indeed, in *Bankers Life*, this Court squarely held that Section 10(b) encompasses cases in which the proceeds from a securities sale are improperly misappropriated, even if the execution of the securities sale itself was conducted at a fair market price and was not otherwise fraudulent. *Bankers Life*, 404 U.S. at 11. Because the Commission's complaint alleges that respondent sold securities without authorization from his clients in order to misappropriate the proceeds from those sales for his personal use, the Commission has plainly stated a violation of Section 10(b) and Rule 10b-5 under the teaching of *Bankers Life* and its progeny.

The decision below is also inconsistent with Congress's purposes in enacting the Exchange Act. The federal securities laws were adopted to protect investors from fraud and to bolster the public's confidence in the integrity of the securities markets. The decision below will undermine investor confidence and inhibit market participation by limiting the protective scope of Section 10(b) and Rule 10b-5.

The decision below also creates a potential gap in the protection afforded to investors by the federal securities laws. Although self-regulatory bodies can help regulate and deter misconduct by broker-dealers, the efficacy of those alternative enforcement mechanisms is subject to significant limitations. In the absence of oversight and enforcement by the Commission (under the aegis of Section 10(b) and Rule 10b-5 or otherwise), any unscrupulous elements in the broker-dealer industry will face fewer disincentives to engage in the type of improper securities practices that occurred here. For those reasons, the judgment of the court of appeals should be reversed.

ARGUMENT

THE COMMISSION HAS CLEARLY STATED A COGNIZABLE VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 UNDER SETTLED LAW

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device." 15 U.S.C. § 78j(b). SEC Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," "[t]o employ any device, scheme, or artifice to defraud." 17 C.F.R. § 240.10b-5. Because respondent defrauded Wood by selling the securities in the joint investment and mutual fund ac-

counts for his own benefit and without authorization, and misappropriated the proceeds from those transactions for his own purposes, his conduct satisfies the "in connection with" requirement of the Exchange Act and Rule 10b-5.

A. Respondent's Deceptive Scheme Was Executed "In Connection With" The Sale Of Securities

The Commission's complaint alleged that respondent improperly misappropriated proceeds from the joint investment account and mutual fund account by making checks drawn on those accounts payable to himself or by diverting checks drawn on those accounts that had been made payable to Wood and Okstulski. *See* Pet. 28a-29a. As the complaint alleges, the funds used to honor *all* of those checks were generated by unauthorized sales of securities in either the joint investment account or mutual fund account. *See id.* This Court's precedents make clear that those allegations are more than sufficient to state a violation of Section 10(b) of the Exchange Act and Rule 10b-5.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), this Court held that Section 10(b) applied to misconduct substantively indistinguishable from the conduct that respondent is alleged to have engaged in here. In *Bankers Life*, the defendants induced a company's board of directors to authorize the sale of Treasury bonds for fair market value and then misappropriated the proceeds of the sale for their own purposes. 404 U.S. at 9. Adopting an argument virtually identical to that presented by respondent here, the Second Circuit in *Bankers Life* had concluded that no claim under Section 10(b) was available because, "*with respect to the terms of the sale itself*[,] neither the purchaser nor the seller of the bonds was deceived or defrauded." 430 F.2d at 360 (emphasis added). The "fraud which harmed the plaintiff," the court of appeals stated, "consisted of the failure of [the defendants] *to account for the proceeds*" of the bond sale. *Id.* (emphasis added). Much like the Fourth Circuit in this case, the Second Circuit in *Bankers Life* opined that

"[t]here is a structural difference between *the sale* of the corporation's bonds"—conduct, the court of appeals acknowledged, that was regulated by the Exchange Act—and "the subsequent fraudulent misappropriation of the proceeds received" from the transaction, to which Section 10(b) did not apply. *See* 430 F.2d at 360 (emphasis added).

This Court rejected that reasoning in its entirety, deeming it "irrelevant" that "the proceeds of the sale" were "misappropriated." 404 U.S. at 10. What mattered, this Court stated, was not whether the actual *sale* of the bonds was legitimate, or whether a fair "market price was paid for th[e] bonds," but rather whether "the purity of the security transaction and the purity of the trading process were unsullied." *Id.* at 9-10 (citation omitted). As to that issue, this Court stated, "Section 10(b) must be read flexibly, not technically and restrictively" and should extend to injuries suffered "as a result of deceptive practices touching [the] sale of securities." *Id.* at 12-13. Because the board had been "duped into believing that it * * * would receive the proceeds," the Court concluded, the harm it suffered as a result of the misappropriation of the bond sale proceeds gave rise to a valid claim under Section 10(b). *Id.* at 9.

The facts alleged in the Commission's complaint are substantively indistinguishable from the claims at issue in *Bankers Life*. Like the corporate board in that case, Wood and Okstulski were "duped into believing that [they] * * * would receive the proceeds" of any securities transactions in their accounts. *Bankers Life*, 404 U.S. at 9. Similarly, as was the case in *Bankers Life*, the fact that funds may have been misappropriated from otherwise valid securities sales is "irrelevant" (*id.* at 10), because respondent's deceptive scheme sullied the "purity of the trading process." *Id.* at 10. Indeed, *Bankers Life* itself cited with approval a case holding that a broker violates Section 10(b) when he sells securities without client authorization and misappropriates the proceeds for his personal use. *See Bankers Life*, 404 U.S. at 11 n.7 (citing

Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 979 (S.D.N.Y. 1964)).[5]

The court of appeals attempted to distinguish *Bankers Life* on the ground that "the defendants made misrepresentations about a particular security that induced another party [to] * * * sell the security." Pet. 13a. But as both the Second Circuit and this Court recognized in *Bankers Life*, the misrepresentations at issue in that case had *nothing* to do with the attributes of the bonds at issue, or with the fairness of the sale of the bonds, but rather with the defendant's failure "to account for the proceeds" of the bond sale. 430 F.2d at 360. The court of appeals' attempt to distinguish *Bankers Life* is therefore entirely unavailing. *Bankers Life* controls this case, and the Court should follow it here. Neither party has called for *Bankers Life* to be overruled.[6]

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[5] The plaintiff in *Cooper* brought an action under Section 10(b) and Rule 10b-5 against a trust company and brokerage firm alleging that these defendants had orchestrated a scheme whereby stock the plaintiff had purchased and pledged to the trust company as collateral for a loan was sold by the brokerage firm without authorization and the proceeds misappropriated by the trust company, brokerage firm, and lender. *See* 226 F. Supp. at 974-75. Although there "[wa]s no wrongdoing alleged affecting the value of the stock" at the time it was purchased by the plaintiff or sold by the defendants (*id.* at 977), the district court denied the trust company's motion to dismiss, holding that Rule 10b-5 extends to cases in which the "plaintiff received his full value for the stock purchased" but "ultimately retained nothing as a result of the fraudulent" sale of the stock and misappropriation of the proceeds. *Id.* at 978. The district court noted that the SEC had "consistently viewed" cases in which "brokers who * * * sold a customer's stock and diverted the proceeds to their own pockets" as presenting violations of Section 10(b) and Rule 10b-5. *Id.* (citing SEC authorities).

[6] Leading commentators have uniformly concluded that "the 'in connection with' element as adumbrated by [*Bankers Life*] * * * require[s] some nexus but not necessarily a direct and close relationship between the fraud and the purchase or sale of a security." LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 963 (4th ed. 2001) (collecting authorities). They note that "courts have had no diffi-

[Footnote continued on next page]

The decision below is also inconsistent with this Court's decision in *United States v. O'Hagan*, 521 U.S. 642 (1997). In that case, O'Hagan, a partner in a law firm, learned from colleagues about a proposed tender offer to be made by one of the firm's clients. 521 U.S. at 647-48. The partner traded on that information (by purchasing call options in the target's stock) without making any disclosure to the firm's client (or to anyone else). *See id.* When the government prosecuted him for committing a criminal violation of Section 10(b) and Rule 10b-5, O'Hagan claimed that his conduct, however improper, was not "fraud" committed "in connection with" the purchase or sale of securities. *See id.* at 650-57. This Court rejected that argument, holding that O'Hagan's conduct constituted a breach of fiduciary duty to the law firm's client, and that the breach was "consummated," not when the confidential information was obtained, but when "without disclosure to his [client], he use[d] th[at] information to purchase * * * securities." *O'Hagan*, 521 U.S. at 656.

The court of appeals recognized that *O'Hagan* "certainly expanded the scope of the in connection with requirement" (Pet. 11a), but concluded—as it did with respect to *Bankers Life*—that the case was not "control[ling]." Pet. 11a. According to the court of appeals, *O'Hagan* was inapposite because respondent, unlike O'Hagan, did not misappropriate any confidential information and because respondent's goal was not "to gain guaranteed profits through the purchase or sale of securities" but instead "simply to steal the Woods' assets." *Id.* at 12a.

O'Hagan, far from being distinguishable, completely forecloses respondent's attempt to evade liability under Sec-

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[Footnote continued from previous page]

culty establishing the in connection with element in insider trading or *misappropriation cases*." *Id.* at 966 (emphasis added); *see also* 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 8.4 at 525 (2d ed. 2001) (same).

tion 10(b). Indeed, the case for liability under Section 10(b) and Rule 10b-5 is even *stronger* here than it was in *O'Hagan*. Respondent misappropriated from his clients not merely *information*, but their securities and the proceeds from the sale of those securities. Moreover, respondent deliberately deceived the actual owners of the securities in which he traded (*i.e.*, Wood and Okstulski), whereas O'Hagan's deception of his law firm did not affect any participants to his subsequent securities trades (*see O'Hagan*, 521 U.S. at 655 n.6). This case thus falls squarely within the rule of *O'Hagan*.

B. The Federal Interest In Protecting Investors Counsels In Favor Of Extending Liability To Respondent's Conduct

The decision below thus cannot be reconciled with this Court's precedents construing Section 10(b) of the Exchange Act and Rule 10b-5. Rather than adhere to the teaching of those cases, the court of appeals repeatedly described the Commission's claims as resembling "more a state law tort of conversion" or "more an actionable state law fraud than a federal securities violation." Pet. 10a, 12a. Invoking the truism that "Congress, in enacting the securities laws, did not intend to provide a federal remedy for all common law fraud" (Pet. 8a), the court of appeals concluded that "the goal of § 10(b) would *not* be served" by extending liability to the Commission's allegations against respondent. *Id.* (emphasis added).

The court of appeals' reliance on the congressional intent not to "subsume significant areas of state law" (Pet. 14a) is doubly flawed. First, it is well-settled that the federal securities were not enacted to proscribe *only* those fraudulent schemes that are not otherwise actionable at state law. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478 (1977) ("the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy"). To the contrary, Congress chose language in Section 10(b) that was deliberately expansive.

Rather than enact a statute making it unlawful to commit fraud "in a securities transaction," Congress proscribed fraud "in connection with" a securities transaction, because its aim was to prohibit not only garden-variety misrepresentations but also "unique," "novel," or "atypical" deceptive devices that securities traders might employ on unsophisticated investors. *Bankers Life*, 404 U.S. at 11-12. Indeed, Congress could not possibly have intended to proscribe only conduct that is not otherwise actionable under state law, given that in virtually every case of securities fraud, it is at least theoretically possible to reformulate the allegations as a breach of a state-law duty. Thus, although the court of appeals correctly observed that the "securities fraud provisions [do not] encompass *every* conversion or theft that happens to involve securities" (Pet. 14a (emphasis added)), it is equally true—and dispositive in this case—that if "fraud [is] used 'in connection with' [a securities transaction], there is redress under [Section] 10(b), *whatever might be available as a remedy under state law*." *Bankers Life*, 404 U.S. at 12 (emphasis added); *see also* 15 U.S.C. § 78bb(a).

Second, the court of appeals' analysis wholly ignores that Congress's *principal* purposes in enacting the Exchange Act were "to protect investors" (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976)) and to maintain "investors' confidence in the financial markets" (*Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982)). This Court has repeatedly recognized that "investor protection was a constant preoccupation of the legislators" (*United States v. Naftalin*, 441 U.S. 768, 776 (1979)), and that Congress sought to achieve that goal by "implementing a philosophy of full disclosure" (*Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988)), and by requiring "a high standard of business ethics * * * *in every facet of the securities industry*" (*Naftalin*, 441 U.S. at 775) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-87 (1963)) (emphasis in *Naftalin*).

Congress's twin purposes of "protect[ing] [investors] against fraud" (*Rubin v. United States*, 449 U.S. 424, 431 (1981)), and "promoting investor confidence" (*O'Hagan*, 521

U.S. at 644), would be seriously undermined by a rule placing a broker's unauthorized sales of a customer's securities and subsequent misappropriation of the sale proceeds outside the scope of Section 10(b) and Rule 10b-5. Brokers have become the informational and transactional gateway to the securities markets for large segments of the investing public, so much so that this Court has observed that "the welfare of investors and financial intermediaries are inextricably linked." *Naftalin*, 441 U.S. at 776. Indeed, fully two-thirds of individual investors in the United States now rely on the advice of professional financial advisers, including brokers, when making investment decisions. *See* INVESTMENT COMPANY INSTITUTE AND THE SECURITIES INDUSTRY ASSOCIATION, EQUITY IN AMERICA 7 (Fall 1999). Affirming the judgment of the court of appeals would erode investor confidence because customers undoubtedly will be reluctant to entrust their funds and investment decisions to brokers who play a central role in trading activity but against whom—under the court of appeals' decision—the Commission may have only limited remedies. Moreover, at least with respect to investor-broker relationships, such a rule would revive the very "philosophy of *caveat emptor*" (*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)), that Congress sought to eliminate with the Exchange Act.

To be sure, this Court has cautioned against the danger of construing the "in connection with" requirement so broadly as to make virtually any type of misconduct related to a securities transaction actionable under Section 10(b) and Rule 10b-5. *See, e.g., Santa Fe*, 430 U.S. at 478-79 (cautioning against a construction of Rule 10b-5 that would "bring within the Rule a wide variety of * * * conduct traditionally left to state regulation"). But the risk of overextending Section 10(b)'s scope is simply not presented by this case. All of the monies that respondent misappropriated were generated by respondent's unauthorized sales of his client's securities. Thus, whatever the outer boundary of Section 10(b) and Rule 10b-5 liability may be, respondent's conduct is well within that boundary, under this Court's precedents. Reversal of the decision below will "protect[] investors from fraudulent practices in the sale of securities" (*Naftalin*, 441 U.S. at 774), without "federaliz[ing] [a] substantial portion of [state] law * * * that deals with [such] transactions." *Santa Fe*, 430 U.S. at 463.

C. The Decision Below Creates A Potential Gap In The Protection Afforded To Investors In The Federal Securities Markets

Reversal also will eliminate the significant risk, created by the decision below, that the public will not be fully protected by the federal securities laws from the type of deceptive conduct in which respondent engaged here. In supplemental briefing before the court of appeals, respondent argued that self-regulatory organizations such as the NASD could effectively regulate misappropriation by brokers in the event the Commission did not have authority to police such misconduct under the aegis of Rule 10b-5. The court of appeals referred to those "professional sanctions" in reassuring itself that respondent would "face[] other forms of civil liability" for his misconduct. Pet. 13a. Respondent errs, however, in describing NASD proceedings as a fully adequate alternative to civil enforcement proceedings by the Commission. Although it is undoubtedly true that NASD Regulation would have authority to bring disciplinary proceedings against respondent for misappropriating his client's assets, NASD Regulation's powers to supervise and to punish violations of NASD rules and the federal securities laws were designed to *complement* the Commission's enforcement authority, not to *substitute* for it. Thus, NASD Regulation's regulatory and enforcement authority is more limited than either respondent—or the court of appeals—acknowledges.[7]

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[7] An overview of the self-regulatory scheme established by Congress for the securities industry can be found in *Silver v. New York Stock Exch.*, 373 U.S. 341 (1962); *Sparta Surgical Corp. v. NASD*, 159 F.3d 1209 (9th Cir. 1998); and *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363 (5th Cir. 1980). Examples of NASD Regulation's disci-

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NASD Regulation's enforcement mechanisms are limited to internal, administrative disciplinary proceedings. Unlike the Commission, NASD Regulation is not authorized to bring civil enforcement proceedings against securities violators. Instead, the tools at NASD Regulation's disposal include censure; the imposition of monetary fines and orders commanding disgorgement or restitution; and, for member firms, suspension or expulsion from NASD membership, or, for individuals associated with members firms, revocation of registration or bar from association with a member. *See* NASD Procedural Rule 8310. Those internal disciplinary remedies are applicable *only* to NASD member firms and persons associated with them. NASD Regulation has *no* jurisdiction over non-members, even if those individuals committed or aided and abetted a securities fraud. Indeed, NASD Regulation lacks subpoena power even over its own members (*see* NASD Procedural Rule 8210), and it has no direct authority to obtain information from third parties such as banks and other financial institutions that are subject to compliance with financial privacy laws, absent their voluntary cooperation.[8]

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plinary proceedings against brokers who misappropriate customer assets can be found in *Dist. Bus. Conduct Comm. v. Roach*, No. C02960031, 1998 NASD Discip. LEXIS 11 (Jan. 20, 1998), and *Dist. Bus. Conduct Comm. v. Bavero*, No. C9A920035, 1993 NASD Discip. LEXIS 227 (Sept. 7, 1993).

[8] As a private entity, NASD Regulation does not have subpoena authority. However, NASD Procedural Rule 8210 gives staff authority to:

> (1) require a member, person associated with a member, or person subject to the Association's jurisdiction to provide information orally, in writing, or electronically * * * if requested, with respect to any matter involved in the investigation, complaint, examination, or proceedings; and

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The Commission, by contrast, is empowered to initiate civil enforcement proceedings that subject defendants to compulsory process and the powers of the federal judiciary. Consistent with the Federal Rules of Civil Procedure, the Commission can enforce deposition and document subpoenas issued to defendants and third parties. Institution of civil proceedings also provides the SEC with important mechanisms for obtaining interim relief while charges are pending, including preliminary injunctive decrees and temporary restraining orders. *See* FED. R. CIV. P. 65. NASD rules provide no equivalent provisional remedies during NASD Regulation's disciplinary proceedings.[9] Moreover, the Commis-

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> (2) inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation, complaint, examination, or proceeding.

NASD Procedural Rule 8210. Failure to comply with a request for information may subject a member or person associated with a member to disciplinary proceedings and possible sanctions. All persons registered with the NASD agree as a condition of their registration to comply with all NASD rules and regulations, including Rule 8210. NASD Bylaws, art. IV, § 1; art. V, § 2.

[9] On December 13, 1998, the NASD proposed for comment an amendment to its rules that would increase NASD Regulation's administrative authority over its members but still would not give NASD Regulation the same powers as the SEC. The proposal would authorize NASD Regulation to issue temporary cease and desist orders against NASD members in certain, limited circumstances. *See Notice Of Filing Of Proposed Change And Amendment No. 1 Thereto By The National Association Of Securities Dealers, Inc. Relating To The Issuance Of Temporary Cease And Desist Orders*, 63 Fed. Reg. 71,984 (December 30, 1998). Failure to comply with an administrative cease and desist order would authorize NASD Regulation to suspend or expel NASD member firms or to revoke the registration of their associated persons. *Id.* at 71,990. The proposed rulemaking explains that "there is a clear need for an additional tool to stop members' or associated persons' misconduct that causes significant dissipation of or conversion of assets or other significant harm to

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sion is empowered to seek injunctions to prevent threatened violations of the securities laws, but NASD Regulation has no comparable power. Indeed, NASD Regulation must rely on the Commission to seek injunctions to prevent violations of NASD rules. *See* 15 U.S.C. § 78u(e); *Lang v. French*, 154 F.3d 217, 220 (5th Cir. 1998).

The Commission also has much broader authority to *enforce* its orders than does NASD Regulation. The failure to comply with a court order or judgment in an SEC enforcement proceeding may subject parties to civil and possibly criminal contempt proceedings, in which substantial fines and even imprisonment can be imposed. *See, e.g., Ex parte Robinson*, 86 U.S. (19 Wall.) 505, 510 (1874) ("The power to punish for contempts is inherent in all courts; its existence is essential to the preservation of order in judicial proceedings, and to the enforcement of the judgments, orders, and writs of the courts, and consequently to the due administration of justice."). By contrast, NASD Regulation's authority to punish noncompliance with its disciplinary sanctions is limited to the power to expel member firms and associated members from NASD membership—a power the Commission also possesses. NASD Regulation has no independent authority to enforce its disgorgement or restitution awards in federal court and (absent action by the Commission) must instead file state-court actions that seek to enforce those orders on a

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investors while a disciplinary action is pending." 63 Fed. Reg. at 71,987. The proposal explains that "under the NASD's current rules, it takes a minimum of four months to complete a disciplinary proceeding" and that existing provisions governing the summary suspension of members apply only to failures to pay dues, fees, assessments, or other charges, or to failures to comply with an arbitration award, and cannot be invoked "to stop ongoing, violative conduct while an underlying disciplinary proceeding is being litigated." *Id.* at 71,987-88. The proposed rule remains under review by the Commission and, as noted above, the rule, even if adopted, would not alleviate the enforcement problems identified in the text.

contract theory. Indeed, unlike the SEC, NASD Regulation has *no* authority to subpoena banks, credit card companies, or other financial institutions to obtain information about a broker's assets in order to enforce a restitution award.

Thus, although NASD Regulation has the mandate and the authority to discipline NASD members and associated persons for violations of the federal securities laws and NASD rules, its disciplinary authority is different *in kind* from the SEC's civil enforcement authority. As a private nongovernmental organization, NASD Regulation lacks many of the powerful enforcement tools that are available to the Commission. *See Ernst & Ernst*, 425 U.S. at 195 (noting that Congress provided the Commission "with an arsenal of flexible enforcement powers"). Oversight by NASD Regulation is undoubtedly the critical, first line of defense in policing fraud in the federal securities markets. But the self-regulatory scheme is not a substitute for the powers of the Commission to police fraud under Section 10(b) and Rule 10b-5. Respondent is therefore incorrect in suggesting that any "enforcement gap" resulting from a narrow interpretation of Section 10(b) and Rule 10b-5 will be addressed by self-regulation.

The practical consequence of the decision below will be that similar frauds will be much more difficult to deter and to punish. Although such conduct could still be prosecuted as a violation of the mail or wire fraud statutes, neither the Commission nor NASD Regulation can bring actions under those statutes, and the Department of Justice cannot realistically be expected to prosecute all such violations. Moreover, it has long been recognized that Section 10(b) and Rule 10b-5 are "more effective than the Mail [and Wire] Fraud Statute[s]" precisely because "Congress has given the SEC the long-range weapon of injunction with which to combat threatened or continuing violations of [those provisions]." Alexander H. Frey, *Federal Regulation of the Over-the-Counter Securities Market*, 106 U. PA. L. REV. 1, 16 (1957). The decision below thus eliminates a crucial protection for investors in the securities markets and over the long run will harm investor

confidence and invariably lead to other frauds similar to those perpetrated by respondent.

CONCLUSION

The court of appeals erred in remanding the case to the district court with instructions to dismiss the Commission's complaint. As alleged by the Commission, respondent's deceptive scheme was plainly executed "in connection with" the sale of securities, and under this Court's precedents gives rise to a valid claim for relief under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. Moreover, the court of appeals' interpretation of the statute threatens to undermine investor confidence and to create a regulatory gap in the congressional scheme for overseeing the securities industry. The judgment of the court of appeals should be reversed.

Respectfully submitted.

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